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19 February 2013

The Chief Executive
All authorized institutions

Dear Sir/Madam,

BCBS Revised Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions

As you may be aware, the Basel Committee on Banking Supervision (“BCBS”) published *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions* on 15 February 2013 (see <http://www.bis.org/publ/bcbs241.htm>).

This document updates, and replaces, earlier guidance issued by the BCBS in 2000, by providing more comprehensive and detailed guidance on governance arrangements and the management of a much wider spectrum of FX settlement-related risks, including principal risk (which was the main focus of the earlier 2000 guidance), replacement cost risk, liquidity risk, operational risk, legal risk as well as guidance on the maintenance of adequate capital for FX settlement-related risks. The key recommendations emphasise the following aspects:

- A bank should ensure that all FX settlement-related risks are effectively managed and that its practices are consistent with those used for managing other counterparty exposures of similar size and duration, while taking into account any features that are specific to FX transactions;
- A bank should reduce its principal risk as much as practicable by settling FX transactions through the use of financial market infrastructures that provide payment-versus-payment (“PVP”) arrangements. Where PVP settlement is not practicable, a bank should properly identify, measure, control and reduce the size and duration of its remaining principal risk;

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- A bank should ensure that when analysing capital needs, all FX settlement-related risks should be considered, including principal risk and replacement cost risk, and that sufficient capital is held against these potential exposures, as appropriate; and
- A bank should use legally enforceable netting arrangements and collateral arrangements to reduce its replacement cost risk and should fully collateralise its mark-to-market exposure on physically settling FX swaps and forwards with counterparties that are financial institutions and systemically important non-financial entities.

The HKMA will take the necessary steps to revise its Supervisory Policy Manual module TA-2 “Foreign Exchange Risk Management” to bring it in line with the revised guidance. In the meantime, all authorized institutions are encouraged to review their management of FX settlement-related risks in the light of the revised BCBS guidance and take appropriate action to address any material deficiencies or gaps identified.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)

c.c. The Chairman, The Hong Kong Association of Banks
The Chairman, The DTC Association
FSTB (Attn: Mr Jackie Liu)